Moody's Investors Service
Municipal Credit Research

New Issue Report
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California (State of)

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Moody's Rating

Issue		Rating
State of California Public Education Facilities Bonds, Series E		A1
Sale Amount	$600,000,000.00	
Expected Sale Date	04/21/98	
Rating Description	General Obligation Bonds	

Opinion

Moody's Investors Service has assigned a rating of A1 to the above-referenced State of California General Obligation Bonds, which are being issued to retire short-term commercial paper notes used to finance certain local capital facilities. The rating is a product of the State's credit strengths, including its robust economy, as offset by a financial position that is still weaker than that of most states, and a moderate though slowing increasing debt position which is likely to grow given the demand for capital projects and a not yet established process for allocating debt capacity.

The proceeds of the Bonds are being used to refinance capital facilities, plus in some cases costs of program operation, for public purposes of financing K-12 education facilities. Payment of principal and interest on the Bonds is subject only to the prior application of General Fund receipts to support the State's public school system, and its public institutions of higher education.

The rating of A1 reflects the credit factors discussed below.

ROBUST ECONOMY HAS ENABLED STATE TO IMPROVE FINANCIAL POSITION

The state's A1 general obligation rating is a product of the State's credit strengths, especially its robust economy. The economic recovery is now well-established and broad-based, with the State outpacing the United States and well positioned for further expansion. This expansion is expected to continue, though the State's revenue forecasts have been tempered, taking into account the anticipated adverse effect the current economic crisis in Asia will have on California exports to the region. Current estimates of the negative net impact the crisis will have on the State's gross state product range from a low of .5% to 1.1%.

Recently released California economic data for 1997 clearly illustrate the negative impact that weakening Asian economies have had on California exports. Exports to Japan, the State's largest trading partner, fell by approximately 7.4% ($1.4 billion) from its 1996 total of $18.9 billion. And sales to Korea decreased by $1.5 billion, a 17.7% annual decline. However, gains in other countries - particularly Mexico in which the State realized a gain of $3 billion - enabled the State to realize growth in exports of 6.1% for the calendar year.

The State Budget, with its reliance on economically sensitive sales taxes and personal and corporate income taxes, has benefited from renewed economic growth. As a result, the operating budget has been balanced for the past two years, even while mandated education spending has increased and tax rates have been reduced. And as it did in the previous fiscal year, the State ended 1997 without reliance on external inter-year cash-flow borrowing. Still the General Fund is expected to close the current fiscal year indebted to the State's special funds by over $2.0 billion.

Despite strong economic trends, the State continues to face a sizable GAAP-basis unreserved, undesignated General Fund deficit, reflecting the deficits accumulated in the early 1990s and the constraints of ballot initiatives that hamper fiscal flexibility. Spending pressures, especially for education and public safety, will likely prevent the state from accumulating any significant level of reserves relative to its budget.

DEBT BURDEN PROJECTED TO INCREASE

The State's debt position is moderate though slowly increasing, and likely to grow given the demand for capital projects and a not yet established process for allocating debt capacity. The Governor has proposed an additional $7 billion in bond sales over the next year to support infrastructure spending for elementary and secondary education, higher education, correctional facilities, water and other projects.

The State Treasurer, in the Fall 1997 debt affordability report, recommended that the State limit its future borrowings so that its debt service ratio (i.e., debt service as a % of General Fund revenues) would not exceed 6%. The State's current debt service ratio is 5%. If the State receives voter approval to issue an additional $7 billion in bonds, its debt service ratio will rise to 5.9%.

LOW RESERVES DESPITE REVENUE GROWTH

In contrast to many states in the Aa category, planning for potential economic softening has not been evident in California budget policy during the current expansion, and the revenue dividend from the improving economy has been entirely devoted to enhancing spending, primarily in education, and to tax relief. Given the narrow reserve level and lack of flexibility, financial condition and liquidity would be likely to deteriorate rapidly in an economic downturn.

The Governor's Fiscal 1999 Budget as submitted in January of this year projects that the budget reserve will be $296 million at June 30, 1999, slightly lower than the projected level of $329 million at the end of the current fiscal year. General Fund cash receipt totals through March 31, 1998, are running slightly above year-to-date estimates per the Governor's budget estimates. Conversely, disbursements are 1.6% below the estimate, which bodes well for the likelihood that such projected $329 million reserve level will be met or even exceeded for the current fiscal year.

Outlook

The outlook on the State of California is positive reflecting moderate debt load and substantially improved economic condition offset by a weak, though slowly improving, financial position. Based on current projections, Moody's does not expect economic conditions in Asia to disrupt the State's economy to an extent so as to warrant a change in this outlook.